

Achieving Sustainable Economic Reforms in Greece in 2011 and Beyond

Bob Traa, Senior Resident Representative in Athens, International Monetary Fund
Washington D.C., June 7, 2011

Ladies and gentlemen, thank you for inviting me to speak with you today, with a special word of gratitude to the organizers. I am pleased to share some thoughts on economic developments in Greece and prospects for the banking system.

More precisely, I will touch upon three items: (i) where is economy policy today? (ii) the need to reinvigorate policy momentum, and (iii) what is the task for banks?

A. Where is economic policy today?

Greece has come to a critical point. The country faces an important choice between continuing with the bold reform program to build a modern and competitive economy that provides growth and jobs; or, in the face of the difficult headwinds, to allow the pace of reform to slow. We believe that would be a mistake, because it would prolong the difficult times, rather than help resolve them.

Please recall that just over a year ago the economy was in dire straits, sinking into a deep recession and facing acute fiscal and external pressures. It was against this background that the economic reform program was begun and I will argue that this bold effort has had a positive impact, contrary to the perception in some quarters that advancements under the program have been insignificant. Let me highlight some examples:

- The fiscal deficit. The deficit was cut by 5 percent of GDP despite a recession of 4½ percent of GDP—this is a major achievement;
- Inflation remains too high in the headline but it is declining. Indeed, net of temporary tax effects, it has been running well below the euro-average since July 2010;
- Competitiveness is improving, with unit labor costs falling significantly;
- Dynamic adjustment. The structure of the economy is changing with net exports now leading growth, thereby beginning to offset the moderation in domestic demand;
- The banking system. Very germane to today's topic, banks have been resilient and maintained adequate capitalization (with several large banks going to the market);

In addition, the country has also started an ambitious agenda of broader structural reforms:

- A major pension reform—one of the boldest in Europe—has materially strengthened solvency;
- Labor market reforms have made a step forward toward greater flexibility by cutting hiring and firing costs, and allowing firm-level employment contracts;
- Service sector reforms have begun to free up transport and restricted professions, while business environment reforms are simplifying start-up and licensing procedures, and approval processes for large investments.

In short, the country has had significant accomplishments in 2010 for which, also in comparison with other crisis countries that I have been involved with, it deserves credit.

Regrettably, however, the task of continuing these achievements has been made more difficult by stiff headwinds from a worsening domestic and external political environment:

- First, after a period of improving confidence in the third quarter of 2010, market turmoil elsewhere in the Euro area put renewed pressure on Greek spreads,
- Second, wavering political support for the program and domestic infighting, combined with mixed messages from Euro area partners, has increased uncertainty.
- Third, recurrent discussions of private sector involvement have raised market fears that undermined the credibility of Greece's commitment not to restructure the debt.
- And fourth, the ratings of the sovereign, the banks, and their structured financing products have been downgraded, complicating liquidity management.

In this context, since the end of 2010 the implementation of the reform process has lost momentum, now placing the government's program at a crossroads:

The structural fiscal reforms have been slow to show yields, and as a result the reduction of the fiscal deficit has had to include significant temporary fixes (such as cash expenditure compression (with arrears) and one-off measures). Without deepening these structural fiscal reforms, however, the deficit could get stuck at 10 percent of GDP going forward.

In addition, implementation of the broader real economy structural reforms has also slowed down in 2011. This means that adjustment is increasingly coming from pressure of the recession on unemployment, rather than through productivity gains and a well-lubricated reallocation of resources in the economy. Our concern is that without implementing further reforms, the economy will rebalance through lower incomes and living standards (i.e. lower demand), rather than through higher productivity and output (i.e. higher supply).

B. The need to reinvigorate policy momentum

For these reasons, it is of paramount importance to reinvigorate reform efforts and unlock economic growth potential. Making progress will require implementing reforms in four key areas:

- First, the authorities' medium-term fiscal strategy and the legislation necessary to implement its measures need to be approved by parliament. This strategy aims to reduce the deficit to below 3 percent of GDP by 2014, thereby putting the debt ratio on a downward path, while ensuring a fair sharing of the adjustment burden. The focus is on consolidating state entities, tax policy, public administration reform, and better targeting of social spending.
- Second, the privatization plan also needs to be approved by parliament, and the process of asset sales should begin without delay. No-one can accuse Greece of being half-hearted if the country achieves its privatization targets through 2015

- Third, in the area of fiscal institutional reforms, the anti-tax evasion plans need to yield results, and spending controls and fiscal reporting needs to be fully implemented.
- Fourth, implementation of the broader real economy structural reforms to improve the business environment and employment needs to be pursued with renewed vigor. Examples include: (1) collective bargaining reforms and subminimum wage possibilities need a further push; (2) the “fast track” investment procedure finally needs to live up to its name and be broadened to additional investment projects, not just selected big ones; (3) slow phasing-in of liberalization of regulated professions or truckers reforms, needs to be avoided in future—reforms need to become effective immediately. There is a host of other reforms that have been started but where their potential has not been exhausted by any means—these also need a new dose of energy and effectiveness.

Pursuing these reforms will open up opportunities for investment and underpin greater confidence. We believe that the Greek adjustment program can be successful, and this success will also hinge on three other vital factors:

- The Greek authorities must speak with one voice, leaving no doubt about their resolve to achieve fiscal consolidation and improve growth potential.
- At the same time, Greece’s partners in the euro area also need to speak with one voice and commit firmly to the program, leaving no doubt about their continued financial and political support for the country’s efforts.
- Finally, the Greek banking system will also play a crucial role in leading the way to economic recovery, by financing investment and trade, and supporting the macroeconomic and fiscal programs. So let me now turn to the prospects for the banking system.

C. The tasks for banks

The crisis has put Greek banks under strain.

- Banks weren’t overly leveraged at the beginning of the down turn, but many of them increased their sovereign exposures in the run-up to crisis, also by leveraging available low-cost ECB refinancing.
- With funding subsequently reduced, the system now faces a liquidity challenge. Banks have been shut off from the wholesale funding markets (except for some sporadic and costly access), and the deposit base has been shrinking due to the impact of the recession and the steady current account deficit. ECB exceptional support has helped, but will have to be unwound over time.
- The system also faces a challenge to preserve adequate levels of capital. Non-performing loans are on the rise, dragging profits down. And the exposures to the sovereign have reduced banks’ valuations, making it important further to raise capital. The program envisages several policy channels by which to support financial stability:

The government and central bank have the tools to provide liquidity support, within the ECB’s exceptional support mechanisms. Government guarantees for bank bonds have been effective in providing support to banks, and a new tranche is being prepared. The Bank of Greece has other instruments at its disposal as well.

For capital support, the Financial Stability Fund has been made available as a backstop for viable banks that cannot raise capital in the private market. FSF needs are regularly reviewed to make sure that the fund has adequate amounts available.

Let me stress, however, that the FSF safety net is not meant to substitute for banks' own actions. The onus must be on banks to take care of their own problems to the maximum extent possible. Not least due to the need to achieve greater separation between banks and the sovereign. Banks will need to plan carefully to operate in this environment:

Medium-term funding plans are welcomed. The program recognizes that deleveraging cannot proceed at too fast a pace, lest it undermine asset prices and the recovery itself—a credit crunch must be avoided. At the same time, banks need to extricate themselves from the exceptional support measures provided through the euro system. The funding plans are calibrated to reconcile these tensions, so that the deleveraging can take place at a pace that is consistent with the fiscal and macroeconomic program.

Banks should further increase capital cushions. The uncertainty of how the recession and fiscal adjustment will affect the loan book calls for a capital buffer. As long as doubts exist about the assets held by banks, wholesale market access will likely remain hampered. In this regard, larger capital cushions will help to reduce these doubts.

Now, as the system adjusts to lower leverage, higher capital, and the impact of fiscal adjustment, what should we expect?

- Banks need to work closely with their clients to avoid widespread loan defaults, which could further deepen economic woes. On one side, the legal framework for private loan restructuring can be further improved to optimize this process both for banks and their clients. From the other side, the fate of the Greek sovereign and the banking system also remain closely intertwined: the government depends on banks' continued commitment to maintain exposure. In turn, Greek banks are affected by the sovereign's fiscal predicament, but they also depend on government guarantees for collateral and would be severely hit in any sovereign restructuring scenario.
- Regarding deleveraging of the system, it may take some time for deposits to revive, and banks will undoubtedly make an effort to deleverage via disposal of non-core assets, the reduction of foreign exposures, and other steps as necessary.
- The public sector needs to exit the banking system. The government's privatization strategy envisions the sale of the government's various stakes. This will remove allocative distortions and favor better-yielding investments through private banks.
- Banking sector consolidation is necessary. The entry of additional first-tier international banks as strong partners would bolster the Greek banking system—both for liquidity and capital--and thereby support confidence and the economic recovery.

So, in conclusion, allow me to return to the points we made at the outset:

- Greece stands at a critical juncture with no time to lose.
- The past twelve months have been difficult, but the severe imbalances that have been built up over decades, bringing the economy to the brink of collapse a year ago, have

been managed with more success than is sometimes recognized, even though the recession was unavoidable.

- But good reforms have started and are gaining traction, laying the base for renewed growth. Now is not the time to slow down. Quite the contrary, this is the time to push ahead vigorously to shorten the time period to a new growth cycle.
- Financial sector stability plays a crucial role in the recovery. The basis is there to support financial stability, and banks must do their own part. In particular, banks should seek further capital and improve markets' perceptions of their valuation.

Finally, Greece's growth potential and also its resilience are substantial. A fundamentally sound banking system, a reorientation toward a private-sector led investment and export performance, facilitated by far-reaching economic reforms and public sector retrenchment make for a promising mix. Full implementation of the program is essential. I am convinced that Greece will make the right choice, and as progress is made with a great effort by Greece, the IMF and other partners will gladly offer continued support. Thank you.